

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of hearing with PKF (UK) LLP held on 25 June 2012

1. PKF (UK) LLP (PKF) gave a presentation at the beginning of the hearing and a non-confidential version of this presentation can be found here: Presentations to the CC [provide link]. The following note sets out additional points made by PKF.

Background

2. PKF was founded in 1869 and was currently the seventh largest audit firm in the UK. It operated from 18 offices around the UK. For the year ended March 2011, PKF generated over £100 million fee income and 42 per cent of that came from audit and related assurance work. PKF currently audited 76 listed or AIM companies, including 45 listed companies and 31 AIM companies. It had been appointed by the Audit Commission to audit around 30 local authorities and NHS Trusts. It also provided audit services to large central government bodies as a contractor for the National Audit Office. PKF was one of the ten firms that the Audit Inspection Unit (AIU) publically reported on and was subject to the Audit Firm Governance Code. Under the Code it had appointed two independent non-executives to monitor its commitment to the public interest and to quality.
3. PKF was a member firm of the PKF International network, which was the tenth largest network of accountants spanning 125 countries worldwide. The firms were independent of each other and bound together by an operating licence agreement and a strong global quality control programme to monitor consistency of audit quality.
4. In terms of any particular market expertise, PKF explained that, relative to other firms of its size, it had a number of specializations including, for instance, natural resources, property and construction, and investment companies.

Barriers to entry and expansion

5. PKF said that it perceived a glass ceiling between the AIM market and the full list and even the small cap full list. The 'big four' had an 80 per cent share of the audit services market for small cap full list companies and a 35 per cent share of the AIM market. There was a barrier to entry even at a fledging level of the full list, which was odd as many AIM companies were similar in size and complexity to the bottom end of the full list. It was therefore important to have regard to the full list (rather than focusing solely on the FTSE 350) because as clients at the bottom of the list grew and they stayed with their auditors, their auditors stood to grow with them and so could build a portfolio up to the large firms.
6. PKF considered that many of the banks and particularly their investment/brokerage arms were principal barriers to entry due to their preference for companies to be audited by one of the 'big four'. Some private equity investors also tended to favour the 'big four', but this was less prevalent. The 'IBM principle' also operated with banks and others, including some Audit Committees of larger listed companies. Over the years, however, PKF found that considerable progress had been made with institutional investors and they were increasingly favourable in terms of mid-tier firms being acceptable as auditors of listed companies. This could be explained, in part, by their acceptance of the Financial Reporting Council's (FRC's) market reform

proposals to a larger extent than some other market players and they were also embracing the importance of corporate governance.

7. PKF explained that other barriers to entry included the 'big four' alumni, ie previous 'big four' employees who had become directors and Audit Committee members in FTSE 350 and 100 companies. Limited attention was paid, when selecting auditors, to information on audit quality. A misconception also existed that only the 'big four' had effective global networks. Unlimited liability of auditors was also a potential barrier to taking on some of the larger audits, but PKF noted that this should not be overstated. Loan agreements could also include 'big four' only clauses. PKF thought that prohibiting these clauses would still leave open informal ways where only the 'big four' were considered, eg private equity investment agreements might also contain similar clauses to the bank agreements, or there could be contractual requirements for the approval of any auditor.
8. PKF told us that there were examples of the 'big four' maintaining their public clients by being prepared to discount the price when they were competing against mid-tier firms in order to retain the client. For example, PKF was offered a job for a public client but one of the big four incumbent auditors decreased its fee by 40 per cent when the client was minded to award the audit to PKF.
9. In terms of expansion, PKF's main focus was on targeting entities lower down the FTSE list and trying to grow with them. PKF was asked to tender for a FTSE 350 company only once or twice a year. It was expensive to maintain tender teams as a marketing resource for private sector companies in relation to public sector entities as in the public sector it was appointed by bodies like the Audit Commission rather than the local bodies/central government departments themselves.
10. PKF said that there were currently no incentives to invest in the resources necessary to audit a large number of FTSE 100 and 250 companies without a reasonable prospect of winning a significant market share of those clients. The nature of the investment would be twofold: physical numbers of staff in the right location and more technical department staff together with computer audit staff (PKF had all the necessary expertise but more clients would mean having them in even greater numbers). Although PKF's international network was not nearly as large (in staff numbers) as the 'big four's', it could provide audit services for FTSE 350 companies. PKF said that for international companies, there was no significant difference between how it and the 'big four' would perform the audit. PKF explained that there was a PKF International audit methodology. While its use was not compulsory within the network (unlike the 'big four'), it was very widely adopted, and in putting together international group audit proposals PKF would always expect participating member firms to use it. In this way it was able to provide assurance on consistency of audit quality. PKF (and its international member firms) used the international audit manual for group audits and this would be referred to in tendering. In this way, it was able to provide assurance on consistency of audit quality.
11. PKF considered that audit quality should be a key determinant when selecting audit services including capacity issues. Audit Committees were beginning to refer to the AIU public reports and this is helpful. Information was also published in relation to the Audit Firm Governance Code, the conditions of which were being further developed albeit slowly. PKF suggested that the Code could be an area of focus for the CC's inquiry in terms of remedies. The FRC was also consulting at the moment on where the line would be drawn on AIU public reporting and consequently possibly audit firm governance code requirements, and if this resulted in only the 'big 4' having public reports, PKF thought that this would be a backward step.

12. PKF explained that at the partner level, the profits of the 'big four' were much ahead of the mid-tier firms. This could be considered as a type of barrier to expansion but should not be overstated as the 'big four' had relatively fewer partners in relation to their size and a large director pool from which PKF had recruited. PKF said that it had had no difficulties with attracting talented trainees and its salaries were competitive with the 'big four'. PKF recruited around 60 trainees annually through targeting the same universities as the 'big four' and had no problem retaining trainees after they have qualified.

Remedies

13. PKF said that it did not systematically track examples of where it had suffered from the 'big four syndrome'. However, it gave some examples of where its appointment or continuation of service had been blocked by parties other than the client. These examples involved banks providing finance to PKF's client vetoing its continuance of service. In one case, where the bank had vetoed the continuation of PKF's audit services, the client came back to it after being unhappy with the service provided by one of the 'big four'.
14. PKF explained that its preference was for market-based remedies. Its first preference was for a code requiring the involvement of non-'big-four' companies in tenders (unless the Audit Committee stated in its report that only 'big four' companies were suitable by reference to: quantum of audit resource required; specialized industry knowledge; and network geographical coverage). PKF thought that it would simply be helpful to make people think about the ability of non-'big-four' firms to perform the audit. Alternatively, there could be a requirement for an Audit Committee to explain why the audit could only be done by a 'big four' company when no 'big four' company was invited to tender. PKF preferred market-based remedies on a 'comply or explain' basis over statutory compulsion where businesses were simply required to invite non-'big-four' companies to tender while not being serious about appointing them. A statutory compulsion to tender would also place a subtle emphasis on selling skills of partners rather than good auditing skills.
15. PKF considered that other market-based measures could be introduced to a code, including the requirement for:
 - an Audit Committee report stating whether it was necessary to have a 'big four' firm of auditors, by reference to the above objective criteria;
 - disclosures about alumni, ie where directors or senior financial officers were part of the 'big four' alumni; and
 - there was also an opportunity for the FSA or another body to bring together banks/brokers and non-'big-four' companies subject to AIU reporting to build on the understanding the public reports and the Audit Firm Governance Code should bring.
16. In relation to statutory remedies, PKF would be open to the concept of shared audits, ie auditing parts of groups, but less open to joint audit where both firms signed the audit report on the group. PKF also thought that full-list tendering should be restricted to full-list companies above a certain size. Remedies that PKF did not consider would be appropriate were: breaking up the 'big four', which would be an excessive response; and forcing the 'big four' to become audit only (the firms may focus even more on becoming dominant in the audit market). PKF also did not favour compulsory rotation of audit firms.

17. PKF said that the FTSE 100 and FTSE 250 audit services market would need to become more of a level playing field for PKF to have greater success when marketing and tendering for work. PKF considered that market-based remedies (of the type identified above) would help achieve this.

PKF's capacity

18. PKF considered that it could audit quite a large number of the FTSE 350 companies and some of the FTSE 100 companies. If the market opened up, its focus would initially be on the FTSE 350, eg four in the first year, and then invest in staff and technical resource to take on, say, 15 over a three-year period. PKF did audit companies in the FTSE 350 but not to anything like this extent.
19. The FTSE 100 market had become more restricted over the years, for example 15 to 20 years ago there were non-'big-four' audit companies working with the FTSE 100. Around this time, PKF audited two FTSE 100 companies. In one case, the shareholders asked for a 'big four' auditor and another decided to appoint a 'big four' auditor due to its global presence in a particular part of the world where the company operated.
20. In addition to large public entities, PKF audited private companies that were of comparable scale and complexity to FTSE 350 and FTSE 100 companies.
21. PKF thought that it did not have the size of resources necessary to audit at the top end of FTSE 100 but could compete in the range from the bottom half of the 100 in size terms down through to 350. The 'big four', however, had a size and credibility that existed regardless of their performance on an audit.

Non-audit services

22. PKF said that the FTSE full-list companies were significant purchasers of non-audit services from PKF. A lot of the non-audit work (around 80 per cent) for the FTSE 350 companies was awarded to their auditors. PKF did not see the provision of non-audit services as a way of attracting audit work from listed companies because this work did not often lead to strong contacts at the right level across the organization and with the non-executive directors. PKF said that it, for instance, provided VAT advice to a lot of specialized sector FTSE companies, but it would be unlikely to be appointed auditor.

Competition between the 'big four'

23. PKF thought that there would be a significant reduction in fees if compulsory rotation or tendering was introduced. PKF cited a previously mentioned example (referred to above) of a 'big four' company reducing its audit fees by 40 per cent when faced with competition from PKF.